No. 11787.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent,

and

INEZ H. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONERS' OPENING BRIEF.

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Jurisdiction

Pursuant to the provisions of Sections 272 and 1101 of the Internal Revenue Code (26 U. S. C. A., §272 and §1101) relating to the jurisdiction of The Tax Court of the United States, each of the petitioners above named filed in said Court on May 22, 1944, a petition [R. 5, 18][1] for redetermination of a deficiency in income taxes for

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[1]The abbreviation "R." is used in this brief to refer to the printed Transcript of Record on file herein.

the calendar year 1940 which had theretofore been asserted by respondent Commissioner of Internal Revenue. After answers [R. 16, 30] were filed by respondent, these two cases (together with six other cases involving similar questions) were consolidated for purposes of hearing and briefing in The Tax Court. [Docket entry, R. 2.] A hearing was had on November 12 and 13, 1946, before the Honorable Samuel B. Hill, Judge of The Tax Court, who promulgated his findings of fact and opinion on April 9, 1947. [R. 2, 31-56.] Petitioners' motion for review by the full Tax Court [R. 57-63], filed May 5, 1947, was denied May 8, 1947 [R. 3]; and decisions were entered June 18, 1947, determining a deficiency in income tax for the year 1940 with respect to each petitioner in the amount of $57,474.19. [R. 3, 64, 65.]

Petitioners, being aggrieved thereby, filed with this Honorable Court on September 15, 1947, their petitions for review of said Tax Court decisions. [R. 199, 206.] This Court has jurisdiction to review such decisions pursuant to Section 1141 of the Internal Revenue Code (26 U. S. C. A., §1141); and the venue is properly laid in the Ninth Circuit by reason of the fact that petitioners' returns of federal income tax for the calendar year 1940, in respect of which the asserted liability here in question arises, were filed with the Collector of Internal Revenue for the Sixth District of California. [Stipulation of Facts, para. 4; R. 67.]

Pursuant to petitioners' application therefore, this Honorable Court on September 23, 1947, entered its order that these two cases be consolidated for purposes of briefing and hearing on the basis of a single consolidated record on review. [R. 215, 219.]

Statement of the Case.

The controversy relates to the proper determination of the federal income tax liability of petitioners, husband and wife, for the calendar year 1940. The basic questions are (1) whether the income, if any, resulting from the receipt by petitioners of certain stock of Northrop Aircraft, Inc. (herein sometimes called the "Company") was realized by them in 1939 (as petitioners contend) or in 1940 (as The Tax Court held), and (2) if income was thereby realized in 1940, what was the amount of such income.

There is no substantial dispute as to the basic facts, except with respect to the ultimate fact of fair market value of the stock.

Petitioner John K. Northrop, an aeronautical engineer and aircraft designer, was one of the organizers of the Company, Northrop Aircraft, Inc., a California corporation organized in March, 1939, to engage in the business of designing and manufacturing aircraft and aircraft parts. [Findings, R. 33.] The Company was authorized to issue two classes of stock, known as Class A Common and Class B Common. [Findings, R. 33-34.]

On June 17, 1939, and prior to issuance of any of the Company's stock, a contract [Ex. 3-C][2] was entered into between petitioner John K. Northrop and the Company by which the Company agreed, in consideration for the use of Northrop's name, his past promotional services, and his agreement to be employed by the Company to take

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[2]On January 4, 1949, this Honorable Court made its order granting petitioners' application that the original exhibits, theretofore transmitted to this Court pursuant to order of September 23, 1947 [R. 224], be considered by this Court in their original form without printing [R. 239].

charge of engineering and design for a period of five years at an annual salary of $9,000, to issue to him certain of its Class A and Class B shares on the basis of specified ratios to the number of its Class A shares which should thereafter be sold to the public. He was to receive one Class A share for every 16.25 such shares sold to the public and one Class B share for every 6.5 Class A shares sold to the public. [Findings, R. 34-35.]

That contract provided that as of the date the Company first received cash proceeds from the sale of its shares, and thereafter if and as the Company should issue shares for money or other specified considerations, the Company would issue Class A and B shares to Northrop according to the above ratios. It further provided that Northrop's "right to shares hereunder shall be deemed to have accrued as of the date of the sale of the shares which shall have determined his right thereto * * * notwithstanding the date of actual issuance thereof to" Northrop. [Findings, R. 34-35; Ex. 3-C.]

On June 15, 1939, the California Commissioner of Corporations (herein sometimes called "Corporation Commissioner") issued a permit to the Company to sell and issue its securities [Findings, R. 36; Ex. 1-A, p. 13]; and on June 17, 1939, the Company entered into an underwriting agreement with certain underwriters for the sale of its Class A shares to the public. [Findings, R. 43.] The Company first received cash proceeds from the sale of its shares to the underwriters on July 21, 1939 [Findings, R. 44], and between that date and November 28, 1939, a total of 250,000 of its Class A shares were sold and issued to the underwriters for a cash price of $5 per share. [Findings, R. 45.] The underwriting agreement had originally contemplated the sale of 400,000 Class A

shares to the public, but difficulties encountered in marketing the stock led to a reduction to 250,000 in the number of shares to be sold and a corresponding reduction from $2,000,000 to $1,250,000 in the cash available for the commencement of the Company's business. [Findings, R. 44-45.]

Pursuant to his contract with the Company and by virtue of the sale by the Company for cash of the 250,000 Class A shares during the period July 21, 1939, to November 28, 1939, petitioner John K. Northrop became entitled, not later than November 28, 1939, to receive 15,384 Class A shares and 38,461 Class B shares.

The Corporation Commissioner's permit (1) required that all certificates evidencing shares to be issued to Northrop pursuant to his contract should be held in escrow, until released by the Commissioner, with an escrow holder selected by the Company and approved by the Commissioner, (2) prohibited sale or transfer of any such escrowed shares without the Commissioner's consent, and (3) required, as a condition to issuance of such shares, that Northrop execute a waiver of any right to dividends on such shares while held in escrow and a waiver of any right to participate in any distribution of assets of the Company on account thereof until all stockholders who had paid cash or its equivalent for their shares should have received the full amount of the issuance price. [Findings, R. 36-38; Ex. 1-A, p. 13.]

In June, 1939, the Company designated Bank of America National Trust and Savings Association as escrow holder pursuant to said permit. [Stipulation of Facts, para. 26, R. 71-72; Ex. 11-K.] All that then remained to be done in order fully to comply with the conditions of the permit was (1) to secure the Commission-

er's approval of the escrow holder, and (2) to execute and file the waivers as to dividends and distributions of assets. The Corporation Commissioner's approval of the designated bank as escrow holder was sought by the Company on January 22, 1940, and such approval was given on January 25, 1940. [Findings, R. 38; Stipulation of Facts, paras. 32 and 33, R. 73.] And the required waiver of Northrop's rights with respect to dividends and distributions of assets was dated as of November 30, 1939, was executed January 4, 1940, and was filed with the Corporation Commissioner on January 22, 1940. [Findings, R. 38.]

The certificates evidencing title to the 15,384 Class A shares and the 38,461 Class B shares to which petitioner John K. Northrop had become entitled pursuant to his contract of June 17, 1939, were issued in his name on March 4, 1940, and were forthwith placed in escrow pursuant to the conditions of the permit. [Findings, R. 38-39.] Approximately one-third (5,240) of petitioners' Class A shares were released from escrow by order of the Corporation Commissioner on November 19, 1940. The remaining two-thirds of petitioners' Class A shares and all their Class B shares remained in escrow subject to the aforesaid conditions for more than two and one-half years, or until October 26, 1942. [Findings, R. 41.]

At the time of making the contract with Northrop on June 17, 1939, the Company had also entered into similar contracts with five other men who, like Northrop, had participated in its organization. [Findings, R. 33, 34.] Of this group of six individuals, five (Messrs. Northrop, Cohu, Irving, Bellande and Stephens) had had broad experience in the aircraft industry and were expected to and did take an active part in the management and operation

of the Company. [Stipulation of Facts, paras. 9-13, R. 68-69; testimony of B. P. Lester, R. 144-146.] The sixth, T. T. Ellsworth, was a bond salesman who had no aircraft industry experience and who was not expected to be active in the Company. [Testimony of B. P. Lester, R. 150.] Ellsworth's contract with the Company contained no employment agreement and it provided for the issuance to him of Class A and Class B shares on a much smaller ratio to the number of Class A shares sold to the public. [Findings, R. 34-35.] The aforesaid conditions of the Corporation Commissioner's permit likewise applied to the shares to be issued to the other organizers.

The completion of the sale by the Company of 250,000 Class A shares on November 28, 1939, noted above, entitled Ellsworth under his contract to receive 1,538 Class A shares and 2,307 Class B shares. On the same day, November 28, 1939, in a transaction resulting from personal solicitation and negotiation over a period of ninety days with a party particularly interested in Southern California aviation stocks, Ellsworth assigned his contract with the Company to one A. H. Smith in exchange for 2,500 shares of Duval Texas Sulphur Co. (600 of which Ellsworth immediately sold at 7⅛, and 300 of which, or approximately 12%, were retained as profit by the intermediary negotiating the deal). [Testimony of Carl L. Barnes, R. 129-132; Findings, R. 39.]

No other sale or exchange of any of the escrowed stock occurred at any time prior to the termination of the escrow.

Under the contract of June 17, 1939, between the Company and petitioner John K. Northrop, the Company was granted an option to purchase 60% (or 23,077) of the Class B shares to be issued to Northrop thereunder at the

cash price of 25 cents per share in the event of (a) Northrop's death, or (b) termination of his employment contract by reason of his default. All these Class B shares were to remain subject to the option until August 1, 1941, after which the shares were to be gradually released from the option over the succeeding 3-year period. No such option existed with respect to the shares to which Ellsworth became entitled under his contract. [Findings, R. 35-36.]

In addition to the contract option and the restrictions contained in the Corporation Commissioner's permit, the 38,461 Class B shares received by petitioners were subject to further limitations and conversion rights under the Company's Articles of Incorporation [Ex. 2-B, Article Five], as follows [Findings, R. 41-42]:

(a) Class B shares were not entitled to participate in dividends prior to July 1, 1942, and were to be entitled to dividends thereafter only if specified earnings requirements per Class A share had been met.

(b) Class B shares were not entitled to participate in any distribution of assets on liquidation, dissolution or winding up until the holders of all outstanding Class A shares should have received an amount equal to the consideration received by the Company upon the original issuance thereof.

(c) The Class B shares were to become void if no "adjusted net profits," as defined in the Articles, were earned by the Company during the 5-year period commencing August 1, 1939, or during the 3-year period commencing August 1, 1941.

(d) Class B shares were to become convertible, share for share, into Class A shares on August 1,

> 1944, if "adjusted net profits" had then amounted to fifty cents per Class A share per annum for the preceding 5-year period; or, if such earnings amounted to less than fifty cents per annum, then the Class B shares were to be convertible into a proportionately smaller number of Class A shares. Further, Class B shares were to become convertible, share for share, into Class A shares if at any time prior to August 1, 1944, the "adjusted net profits," computed either from August 1, 1939, or from August 1, 1941, amounted in total to $1,000,000.

None of the Class B shares became convertible prior to August 1, 1942, but on that date all Class B shares became convertible, share for share, into Class A shares. [Findings, R. 42-43.]

As mentioned above, difficulties were encountered in selling the Company's Class A shares to the public in 1939, necessitating retrenchment in the plans for financing the Company. On March 4, 1940, the date of issuance of the certificates evidencing title to petitioners' shares, the Company was new and untried; its factory had just been completed; it faced substantial competition from established aircraft manufacturers having operating plant facilities and proved products on the market; it had no earnings and had paid no dividends, and it had only one order on its books for approximately $760,000. [Findings, R. 44-47.] And by that date it was known that that single order, which had been accepted at an estimated "break-even" price, would result in a loss to the Company. [Testimony of Claude M. Monson, R. 93.]

The Company suffered sizeable net losses in the fiscal years ending July 31, 1940, and July 31, 1941. It first showed earnings in the fiscal year ending July 31, 1942,

and it paid dividends on its stock for the first time in November, 1943. [Findings, R. 47.]

The unrestricted Class A shares of the Company which were sold to the public were never traded or listed on any securities exchange during 1939 or 1940, but were traded on an over-the-counter basis through securities dealers. These unrestricted Class A shares were traded in relatively small blocks of 100 or less, at prices ranging from a low of 5 to a high of 6⅞ during the period from November 9, 1939, to March 8, 1940. [Findings, R. 47-48.]

The respondent Commissioner of Internal Revenue determined that the Class A and Class B shares issued to petitioners as aforesaid were received by them in 1940, when the certificates representing such shares were issued, and that they constituted income in that year in the amount of their fair market value. Despite the highly restricted nature of petitioners' shares, respondent determined that value to be $6.25 per share for both Class A and Class B shares, a figure approximating the then current over-the-counter price for publicly held Class A shares which were subject to no restrictions or options. On this basis, respondent determined deficiencies in 1940 income tax in the amounts of $99,479.05 for John K. and $99,479.04 for Inez H. Northrop.

The Tax Court held that petitioners realized income by virtue of the promotional shares in 1940 as determined by respondent rather than in 1939 as contended by petitioners [Opinion, R. 50-53], but that respondent's valuation of $6.25 per share failed to give sufficient recognition to the restrictions imposed on the promotional shares. The Tax Court found that both the Class A and Class B shares received by petitioners had the same fair market value, to wit: $4.00 per share [Findings, R. 49; Opinion, R.

53-56], and on this basis determined a deficiency in 1940 income tax against each of petitioners in the amount of $57,474.19. [Decisions, R. 64-65.] Thereupon, petitioners filed their petitions for review of such decisions by this Court. [R. 199, 206.]

SPECIFICATION OF ERRORS.

1. The Tax Court erred in deciding that income was received by petitioners, or either of them, in the calendar year 1940 by reason of the issuance in that year to petitioner John K. Northrop of certificates representing 15,384 Class A shares and 38,461 Class B shares of promotional stock of Northrop Aircraft, Inc., a corporation. The Tax Court's holding to that effect, on the basis of uncontroverted evidence, is contrary to law.

2. The Tax Court erred in finding as a fact [R. 49] and in determining that each of the Class A and Class B promotional shares of Northrop Aircraft, Inc. received by petitioners had a fair market value of $4.00 per share, or any fair market value, on March 4, 1940, the date of the issuance of certificates evidencing title to such shares. The Tax Court's holding to that effect is contrary to law and its finding to that effect is not supported by substantial evidence and is clearly erroneous, in the following particulars:

(a) The Ellsworth-Smith exchange, upon which the finding and decision are primarily predicated, constitutes no evidence of the fair market value of petitioners' stock.

(b) There is no other evidence to support the finding, or any finding that petitioners' stock had any fair market value.

SUMMARY OF ARGUMENT.

Petitioners contend on this appeal that The Tax Court erred both in finding that the stock of the Company received by them had a fair market value of $4 per share, or any fair market value at all, and in concluding that 1940, rather than 1939, was the taxable year of receipt of whatever income (if any at all) was realized in connection with said stock. If petitioners prevail on either point The Tax Court's decision must be reversed.

In this brief the issue as to the year of receipt is first considered, and it is contended: first, that equitable and beneficial ownership of shares of the Company was acquired by petitioners in 1939 so that, to such extent as taxable income arose from the entire transaction, it was received in 1939, rather than in 1940, the only year here in issue; second, that the stock was constructively received in 1939, and hence can be taxable only in that year; and, third, that what petitioners received in 1939 was the equivalent of cash, and therefore taxable then and not later. If any of these three contentions is correct the petitioners must prevail in this appeal.

As to the issue of fair market value of petitioners' shares on March 4, 1940, it is submitted that The Tax Court's finding of a value of $4 per share is arbitrary, excessive, not supported by the evidence, and based on

fallacious reasoning. First, the Ellsworth-Smith transaction of November 28, 1939, which the court regarded as "reliable" and "the best available indication" of value of petitioners' stock, is analyzed and shown to be completely unreliable and without evidentiary value as to petitioners' shares, because the ratios of Class A and Class B shares received by Ellsworth on the one hand and by petitioners on the other were very substantially different. Nevertheless an average value per share (of both classes, without discrimination between them) was applied blindly to petitioners' differently assorted shares despite the lack of any evidence that shares of both classes had the same value (if either had any) and without recognition of the facts which make obvious a difference in value between them. In addition, the effect of the option which burdened 43 per cent of petitioners' stock but applied to none of Ellsworth's was erroneously disregarded.

Second, it is contended that there is no other evidence to support the Court's finding of a fair market value of $4 per share for the highly speculative and peculiarly restricted and burdened stock received by petitioners, and that on the contrary the evidence compels the conclusion that they had no fair market value at all.

ARGUMENT.

A. If Any Income Was Realized by Petitioners From the Receipt of the Company's Shares, It Was Received in 1939.

The first issue is whether the income, if any, realized by petitioners by reason of the receipt of shares of Northrop Aircraft, Inc., was received in 1939 as contended by petitioners or in 1940 as The Tax Court decided. Only the year 1940 is involved in this proceeding. Consequently, if the shares or their equivalent were actually or constructively received in 1939, it becomes unnecessary to inquire whether such shares had a fair market value in 1940.

The Tax Court held that the petitioners did not realize income in 1939 by reason of their situation with respect to the shares in question. [R. 53.] The Court reasoned that the petitioners did not actually or constructively acquire any stock or other proprietary interest in the Company in 1939, because the conditions of the Corporation Commissioner's permit authorizing the sale and issuance of such stock had not been fully complied with in that year. [R. 50-52.] The Tax Court also concluded that the contract rights received by petitioners in 1939 did not constitute the equivalent of cash because, as the Court expressed it, "we do not think that petitioners accepted these contract rights as payment." [R. 52-53.] These conclusions, we believe, are wholly erroneous and are not supported either by the facts of the instant case or by the law applicable thereto.

Our position, briefly, is that the nature of the interest in the Company received by petitioners in 1939 was such that it constituted the receipt of income in that year to the extent of its fair market value, if any. It is not of any particular consequence what that interest is called.

The Courts have used various designations for similar interests, such as "proprietary interest," "capital interest," "beneficial ownership," "property interest," "present beneficiary ownership," "economic ownership" and "equitable ownership."[3] The fact remains that petitioners received in 1939 a clearly defined, enforceable property interest in the Company, whatever such interest is called.

Alternatively, we contend that under well settled principles of law the petitioners in 1939 constructively received shares of the Company regardless of whether or not petitioners technically were shareholders in that year.

Finally we believe that the receipt by petitioners in 1939 of the right to the issuance of certificates evidencing shares constituted the receipt of the equivalent of cash so as to constitute receipt of income in that year to the extent of the fair market value, if any, of the right received.

1. Petitioners Received in 1939 Equitable and Beneficial Ownership of Shares of Northrop Aircraft, Inc., the Value of Which, If Any, Was Taxable to Them in 1939.

In order to determine when, if at all, the petitioners realized income from receipt of shares of Northrop Aircraft, Inc., it is necessary to determine just what they received in 1939 and what they received in 1940. Petitioners filed their income tax returns on a cash receipts and disbursements basis. [R. 32.] Under the statute they were required to include in gross income "gains, profits, and income derived from salaries, wages, or compensa-

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[3]*Kansas, O. & G. Ry. Co. v. Helvering* (3 Cir.), 124 F. 2d 460, 463; *Eisner v. Macomber,* 252 U. S. 189, 208; *I. C. Bradbury,* 23 B. T. A. 1352, 1361; *Commissioner v. Timmer* (6 Cir.), 78 F. 2d 599, 600; *Quincy A. Shaw McKean,* 6 T. C. 757, 762; *Schneider v. Duffy* (D. C. N. J.), 43 F. 2d 642, 645.

tion for personal service . . . of whatever kind and in whatever form paid, . . . or gains or profits and income derived from any source whatever." I. R. C. Section 22(a).

There is no doubt as to what was received by petitioners in 1940. On March 4, 1940, Northrop Aircraft, Inc., issued to John K. Northrop certificates (in which Mrs. Northrop had a community interest) evidencing 15,384 of its Class A common shares and 38,461 of its Class B common shares. [R. 39.] These certificates on the same day were placed in escrow with Bank of America National Trust and Savings Association, Los Angeles, California, pursuant to the provisions of the permit issued by the California Commissioner of Corporations, dated June 15, 1939. [R. 39.]

To determine what the petitioners received in 1939, let us examine the uncontroverted facts:

By contract dated June 17, 1939, between the Company and Northrop [Ex. 3-C] the Company as consideration for the use of Northrop's name, his past promotional services and his entering into the contract, agreed to issue to Northrop not exceeding 24,615 Class A common shares and not exceeding 61,538 Class B common shares in the ratio of one Class A share for each 16.25 Class A shares sold to the public and one Class B share for each 6.5 Class A shares sold to the public.

The contract further provided:

> "(d) *Northrop's rights to shares hereunder shall be deemed to have accrued as of the date of sale of the shares which shall have determined his right thereto, or as to shares issued upon exercise of warrants, as of the date of such exercise, notwithstanding the date of actual issuance thereof to Northrop.*" (Emphasis added.)

The considerations furnished by Northrop, enumerated above, for the shares in question were fully paid and performed by Northrop on June 17, 1939, although his rights to the shares by the terms of the contract were conditioned upon the sale of other shares to the public. The events that fixed his rights to shares and the number thereof occurred during the period beginning July 21, 1939, and ending November 28, 1939. [R. 45.] During that period 250,000 of the Company's Class A common shares were sold to the public for cash. [R. 45.] This completed the public sale of the Company's stock under the underwriting agreement as amended. [R. 45.] As of November 28, 1939, Northrop's rights to all of the shares in question had become fixed and determined. On that date, by the terms of his contract with the Company, he was entitled to 15,384 Class A shares and 38,461 Class B shares.

Notwithstanding the foregoing facts, The Tax Court concluded that Northrop did not acquire any stock or other proprietary interest in the Company in 1939 because in that year all of the conditions of the Corporation Commissioner's permit for the sale and issuance of the shares in question had not been fully complied with.

The permit [R. 36-38; Ex. 1-A, p. 13] authorized the Company to sell and issue an aggregate of 51,694 of its Class A shares and 108,307 of its Class B shares to John K. Northrop and five other individuals who had been active in the organization of the Company for the considerations set forth in the Company's application for the permit. The sale and issuance of these shares were conditioned by subparagraphs (b), (c) and (d) of the permit upon the selection of an escrow holder by the Company; the approval in writing of such escrow holder by the Commissioner of Corporations; the execution by Northrop

and the five other individuals of written waivers as to dividend rights, and rights to participate in the distribution of assets, during the period the shares were required to be held in escrow; and the filing of copies of such waivers with the Commissioner of Corporations.

The Tax Court relied solely upon the non-occurrence of certain of these conditions in 1939 to support its conclusion as to the year in which income was received by the petitioners. The escrow holder for the shares in question was selected by the Board of Directors of the Company by resolution adopted June 17, 1939. [R. 71-72.] The waiver agreement required by the permit, relating to distribution and dividend rights, was dated as of November 30, 1939, and was executed on or about January 4, 1940, and an executed counterpart thereof was filed with the Corporation Commissioner on or about January 22, 1940. [R. 38.] Bank of America National Trust and Savings Association accepted its appointment as escrow holder for the shares in question on January 6, 1940, and on January 25, 1940, the Corporation Commissioner approved the appointment of said bank as escrow holder. [R. 38, 72-73.]

Under such circumstances, may it properly be said that petitioners acquired no interest—proprietary, equitable, beneficial or otherwise—in the Company during 1939? We believe that The Tax Court's negative answer to this question is based upon a wholly unwarranted emphasis on the form of the transaction as contrasted with its substance and on a misapprehension as to the application of the California Corporate Securities Act (Deering's Calif. Gen. Laws, Act 3814) to the instant case.

Under the broad equitable principle that "equity regards and treats that as done which in good conscience ought to be done" (2 Pomeroy's Equity Jurisprudence, 5th Edi-

tion, Section 364) it is clear that Northrop became the equitable and beneficial owner of the stock in question in 1939 when he became, by the terms of his contract, entitled to such shares. *Wait v. Kern River Mining etc. Co.*, 157 Cal. 16, 106 Pac. 98; *Fleishman v. Woods*, 135 Cal. 256, 67 Pac. 276; *Virginia Shipbuilding Corporation v. U. S.* (4 Cir.), 22 F. 2d 38, 50.

The equitable doctrine that a person entitled to shares of stock will be treated as the owner of that stock has found frequent application in income tax law. At the outset it is universally recognized by the courts that the certificate is not the stock itself, but is merely evidence thereof, and that a person may be a shareholder without ever receiving a certificate. *Eisner v. Macomber,* 252 U. S. 189, 208; *Kansas, O. & G. Ry. Co. v. Helvering* (3 Cir.), 124 F. 2d 460, 463. The courts have gone on from this point to hold that when, pursuant to a contract, a taxpayer has become entitled to shares of stock, he will then be deemed to have received such stock for tax purposes irrespective of whether he ever receives the certificates evidencing such shares.

Thus in *I. C. Bradbury,* 23 B. T. A. 1352, aff'd. sub. nom. *Commissioner v. Timmer* (6 Cir.), 78 F. 2d 599, the taxpayers were held to have acquired a present interest in a corporation by reason of a contract, notwithstanding that certificates evidencing such interest were never issued to them. A contract entered into to induce the taxpayers to remain in the employ of the corporation provided that the corporation would be reorganized with each of the taxpayers to receive 8% of its common stock, and that pending the completion of such reorganization the property rights of the parties in the corporation should be "precisely as though" its reorganization had become effective and the stock issued April 1, 1920, the date of the

contract. The reorganization never took place and the stock contemplated by the contract was never issued to the taxpayers. In 1925, each of the taxpayers received $200,000 from the corporation upon the cancellation of the 1920 contracts and the surrender of their interests to the corporation. The Commissioner contended that the entire amounts received in 1925 were taxable in that year as compensation for personal services. The Board held, however, that the taxpayers acquired interests in the corporation in 1920 which interests were sold in 1925 and that the gain therefrom constituted a capital gain. The Board said (pp. 1360-1361):

> "Upon consideration of the instrument as a whole, in the light of the surrounding facts and circumstances disclosed by the record, it is our opinion that, immediately upon execution of the contract, petitioners each became the beneficial owner of 600 shares, or 8 per cent, of the common stock of the corporation precisely to the same extent as if the so-called reorganization had been effected on that date and a stock certificate issued to each petitioner for the interest given to him. As such stockholder, each petitioner became entitled on April 1, 1920, to receive dividends upon the stock given to him and to exercise all other rights, privileges and duties of stockholders. . . . The fact that the contemplated 'reorganization' was not effected on said date and stock certificates issued to petitioners is immaterial. A stock certificate merely constitutes evidence of ownership of an interest in a corporation; it is not the stock itself nor essential to the ownership thereof. *Richardson v. Shaw,* 209 U. S. 365; Fletcher on Corporations, Vol. V, p. 5604, §3426."

The Court of Appeals for the Sixth Circuit in affirming the decision of the Board in the *Bradbury* case said (78 F. 2d 600):

> "Under the contract of April 1, 1920, Bradbury and Eifert acquired a present interest in the old corporation and not merely an interest contingent upon its reorganization. . . We think it was the purpose of the old stockholders to give them a property interest in the corporation in order to retain their services, and it is our further view that this purpose was effected upon the execution of the contract. The finding of the Board of Tax Appeals to this effect is supported by both the law and the evidence."

The *Bradbury* case was followed by The Tax Court in *W. F. Marsh,* 12 T. C. No. 144, decided June 17, 1949, on facts strikingly similar to those in the present case. There the question involved was the holding period of shares of stock. On or before October 14, 1943, the taxpayers and others loaned $65,000 to a corporation in consideration of the corporation's promissory notes for $65,000 and 6,500 shares of no par common stock to be issued when authorized by the corporation, said shares to be dated October 14, 1943. In February, 1944, the articles of incorporation were amended to give the corporation permission to issue 10,000 shares of common stock. Stock certificates for 6,500 of these shares were issued on February 26, 1944, but were dated October 14, 1943. Taxpayers sold certain of these shares on May 23, 1944. It was held that the taxpayers became beneficial owners of such shares on October 14, 1943, although the shares were not even authorized by the corporation's articles until February of 1944. The Court said in part:

> ". . . There was never any doubt that petitioners and their associates would be the holders of 6,500

shares of common stock to be issued when authorized and to be dated October 14, 1943. In accordance with the agreement in these proceedings the stock certificates were to be dated October 14, 1943, the date by which the corporation had received the $65,000 and had delivered its promissory notes. No other conclusion can be drawn from the fact that the certificates were to be dated October 14, 1943 than that the parties intended, as in the *Bradbury* case, *supra,* that all rights in the corporation should be established as of a stipulated date. We think it is apparent from the agreement herein that the parties intended to fix the rights of petitioners and their associates as of October 14, 1943.

". . . The fact that the stock was not formally issued until February 26, 1944 is of no consequence as a stock certificate merely constitutes evidence of ownership; it is not the stock itself nor essential to the ownership thereof. *Richardson v. Shaw,* 209 U. S. 365; Fletcher on Corporations, Vol. XI, p. 65, Section 5094."

Obviously the fact that the stock certificates in the *Marsh* case were dated prior to actual issuance thereof was of significance only as evidence of the parties' intent, just as in the instant case the language of the contract between Northrop and the Company, quoted on page 16, above evidenced a similar intent.

Similarly in *Quincy A. Shaw McKean,* 6 T. C. 757, the taxpayer was held to have been the equitable owner of shares of stock, although the shares never came into his physical possession. In 1932 he advanced money to one Bird for which he was to receive an interest in stock of a corporation to be received by Bird. Bird subsequently received the stock, but failed to deliver any part of it to the

taxpayer. In 1939 the taxpayer filed a suit for specific performance of the contract for delivery of the stock. The suit was settled in 1940 by a compromise under which Bird made a cash payment. The Tax Court rejected the contention of the Commissioner that the profit realized by the taxpayer in 1940 by reason of the settlement was taxable as ordinary income or in the alternative as short term capital gain, and held that it was long term capital gain. Referring to a memorandum agreement executed by the parties in 1932, the Court said (pp. 761-762):

> "Under the contract the brokers [taxpayer] made an investment in the stock, they acquired a present beneficial ownership therein, and, pending the clearing up of Bird's financing obligations and the taxes in connection therewith, the brokers were entitled to the dividends on their shares. The fact that the shares could not at that time, and as a matter of fact never did, come into their physical possession is entirely immaterial. *I. C. Bradbury,* 23 B. T. A. 1352; affd., 78 Fed. (2d) 599. They were the equitable owners of one-half of the shares that Bird had acquired. . . .
>
> "We conclude that by the transaction the brokers acquired an economic ownership of one-half of the stock acquired by Bird. . . ."

See also:

Schneider v. Duffy (D. C. N. J.), 43 F. 2d 642, 645, 648.

That The Tax Court in the present case gave scant, if any, recognition to the foregoing principles is obvious from the Court's summary treatment of the problem, as follows [R. 51]:

> ". . . A recognition of the distinction between the issuance of certificates and the issuance of shares

> does not affect our conclusion. Nor does the fact that original subscribers to stock are sometimes regarded as stockholders even absent an issuance of shares have application here. . . ."

Apparently The Tax Court rested its entire decision as to the year of receipt of income by petitioners on the flat proposition that because the conditions of the Corporation Commissioner's permit were not fully complied with in 1939, petitioners did not acquire any stock or other proprietary interest in the Company in that year. Although not cited in its opinion, The Tax Court obviously relied upon Section 16 of the California Corporate Securities Act (Deering's Calif. Gen. Laws, Act 3814, Sec. 16) which as in effect in 1939 provided (1933 Stats., p. 2316):

> "Sec. 16. Every security issued by any company, without a permit of the commissioner authorizing the same then in effect, shall be void, and every security issued by a company with the authorization of the commissioner but which has been sold or issued in nonconformity with the provisions, if any, contained in the permit authorizing the issuance or sale of such security shall be void."

The Tax Court also relied upon *Live Oak Cemetery Association v. Adamson,* 106 Cal. App. (Supp.) 783, 288 Pac. 29. In that case suit was brought against certain individuals on their liability as stockholders of a corporation. The judgment of the trial court for the plaintiff was reversed because the stock issued to the defendants had been issued in violation of the permit issued under the California Corporate Securities Act and was, therefore, void and the defendants were not stockholders. Without questioning the correctness of the decision in the *Live Oak Cemetery* case on its particular facts, we submit that it has no application to the present situation.

It may be observed that subsequent California decisions have modified the "void" rule so that it no longer operates as a rigid criterion in all fact situations but only where it is necessary to carry out the purpose and spirit of the Corporate Securities Act. *Eberhard v. Pacific Southwest L. & M. Corp.*, 215 Cal. 226, 9 P. 2d 302; *Robbins v. Pacific Eastern Corporation,* 8 Cal. 2d 241, 65 P. 2d 42; T. W. Dahlquist, Regulation and Civil Liability Under the California Corporate Securities Act: III, 34 Cal. L. R. 543, 551-554.

More significant, however, is the fact that in the present case there is simply no room for application of the "void" rule. Nothing was done by anyone in violation of the Corporate Securities Act. Conceding The Tax Court's point that a corporation has no inherent power to create proprietary interests independent of sovereign control, we have here a situation where the sovereign by the issuance of his permit expressly authorized the creation of the interests under discussion. Authority to create these interests was granted by the sovereign on June 15, 1939. Upon the completion of the sale of the Company's shares to the public in November, 1939, the Commissioner's permit had been substantially complied with and the petitioners' interests became vested subjected only to the performance of certain ministerial acts required by the Commissioner to protect the general public. The conditions of the permit of June 15, 1939, as regards the escrow of petitioners' shares, related solely to the certificates evidencing such shares and were solely for the protection of persons who might be injured were it possible for certificates evidencing promotional stock to be freely circulated. The waiver agreements required by the permit were merely paper evidence of an encumbrance against petitioners' stock which existed at all times after June 17, 1939, by reason of the

terms of the permit restricting the dividend and liquidation rights of the shares in question.

The actuality of petitioners' interest in the Company in 1939 may be tested by assuming that the Company had become insolvent prior to full compliance with the conditions of the permit and prior to the issuance of certificates. Certainly, under such circumstances Northrop would not be heard to assert that he was a creditor for the value of the considerations furnished by him rather than a stockholder, because his stock was "void" under the literal language of the statute. On the contrary, it seems clear that, under the modern interpretation of the "void" rule, he would have been denied all creditor's rights and would have been treated as a stockholder, his stock being subject, however, to the restrictions as to dividend and liquidation rights imposed by the Commissioner's permit.

An examination of the facts demonstrates that the unperformed conditions of the Corporation Commissioner's permit were essentially formalities and ministerial in character. As of November 28, 1939, all that remained to be done prior to the issuance of the certificates evidencing Northrop's shares were the approval in writing by the Commissioner of an escrow holder already selected by the Company, the execution of the waivers required by conditions (c) and (d) of the permit and the filing of copies of such waivers with the Commissioner. Justus A. Hahn, Assistant Commissioner of Corporations, testified at the hearing [R. 198-199] that the escrow holder actually selected, Bank of America National Trust and Savings Association, or any one of several other Los Angeles banks with trust powers "would be proper as such escrow holders." With respect to the waivers required to be executed and filed with the Corporation Commissioner, such acts

were wholly within the control of the individuals entitled to promotional shares. Moreover, the intent of the Company and its organizers with regard to the time that interests in the Company vested in such individuals is clear from the language of the contract quoted on page 16 above and from the fact that the waiver agreement, itself, was dated and executed as of November 30, 1939 [Ex. 16-p].

J. K. McAlpine Land & Development Co., Ltd., 43 B. T. A. 520, affd. on other grounds (9 Cir.) 126 F. 2d 163, provides an answer to the contention that the interests in the Company received by petitioners were taxable in 1940 rather than 1939. In that case the corporation had issued to the taxpayer 8000 shares of stock in payment for advances made and organization services rendered by the taxpayer. The Commissioner determined an income tax deficiency based on the fair market value of the shares received. The taxpayer contended that the shares were void and had no value because no permit for the issuance thereof had been obtained from the California Commissioner of Corporations. In rejecting this contention the Board said (pp. 525-526):

> "The record before us does not show that any of the recipients of the stock in question ever at any time contended that it was void and of no value. *A security may have value even if it be issued without a permit.* This was the situation in *Western Oil & Refining Co. v. Venago Oil Corporation,* 218 Cal. 733, 24 Pac. (2d) 971, wherein the court said, 'In the case herein the units proved to be valuable, notwithstanding they were issued without a permit.' See also *Julian v. Schwartz,* 16 Cal. App. (2d) 310, 60 Pac. (2d) 887. . . ." (Emphasis added.)

Similarly, in *Southern California Rock and Gravel Co.,* 26 B. T. A. 296, it was held that an exchange of property

for stock of a California corporation was effected for income tax purposes prior to December 31, 1920, notwithstanding that issuance of stock was not authorized by the California Commissioner of Corporations until January 24, 1921. The Board said (pp. 300-301):

> "Tax liability resulting from sales of property is not determined by the date when legal title is transferred or the date on which certificates of stock are received in payment. Such liability is fixed as of the date the real benefits and burdens of ownership are transferred. *Brunton v. Commissioner,* 42 Fed. (2d) 81; *Grace Harbor Lumber Co.,* 14 B. T. A. 996; *Ohio Brass Co.,* 17 B. T. A. 1199; and *T. B. Hoffer,* 24 B. T. A. 22. Ownership of corporate stock may vest prior to delivery of stock certificates. *Richardson v. Shaw,* 209 U. S. 365; *Galbraith v. McDonald,* 123 Minn. 208, 143 N. W. 353; and *T. B. Hoffer, supra.*"

In *S. T. Swenson, Executor,* 14 B. T. A. 675, reversed on other grounds (5 Cir.) 56 F. 2d 544, cert. den. 287 U. S. 618, the board held that the date for valuation of stock received in an exchange was the date that an oil lease was given in exchange and the shares subscribed for, although, because of an injunction, the certificates were not issued until a later year. From the facts of the case it appears that on the date the shares were subscribed for, the issuance of such shares was not authorized by the Company's charter and that if the shares actually had been issued on that date they would have constituted an over-issue. After considering the question of fair market value, the Board said (p. 681):

> "There is another question of law in the case. The respondent contends, inasmuch as the stock certificates

representing the increase of 11,000 shares in the capital stock of the Swensondale Oil Co. were not in fact issued, because of an injunction, until January 6, 1920, at which time the stock may have had a fair market value, that therefore the petitioner is assessable in some amount. Aside from the fact that this contention involves another taxable year than the one under review, it is evident that this transaction was closed with the agreement of April 17, 1919, and that the physical receipt of the certificates of stock was merely an incident thereto, and that the date under which such certificates of stock were issued or upon which they were received is of no consequence whatever. The petitioner's rights and obligations must date from April 17, 1919."

Likewise in *W. F. Marsh, supra,* page 21, beneficial ownership of shares was held to have been acquired from the date of agreement to issue such shares notwithstanding that the shares were not then authorized by the corporation's articles of incorporation and would have constituted an overissue had they been issued without such authorization.

Under the above authorities, we submit that however the interests in the Company received by the petitioners in 1939 are designated—whether as equitable or beneficial ownership of shares, proprietary interests, or economic ownership—they were interests of sufficient substance so as to constitute taxable income to the extent of their fair market value, if any, in 1939. The Tax Court should have so held.

2. Petitioners Constructively Received the Shares of the Company in 1939 When They Became Entitled to Such Shares.

Our position as regards the constructive receipt of shares of Northrop Aircraft, Inc., in 1939 by petitioners has been stated in the alternative because we believe that the authorities fully support our first point—that there was actual receipt of an interest in the Company by petitioners in 1939 which rendered them taxable in that year to the extent of the fair market value of the shares, if any. Obviously, there could not be a constructive receipt and an actual receipt of property on the same date. However, if it is conceded for the purpose of argument that there was no actual receipt of shares or the equivalent thereof by petitioners in 1939, we believe The Tax Court should have held that petitioners in 1939 constructively received the shares to which they had become entitled by contract.

As a preliminary matter, it may be pointed out that it now seems fairly well settled that the doctrine of constructive receipt can be asserted by a taxpayer to defeat an attempt by the Commissioner to assert a tax. In other words, the principle is one upon which the taxpayer as well as the Commissioner may rely. *Ross v. Commissioner* (1 Cir.), 169 F. 2d 483, 490-2; *Weil v. Commissioner* (2 Cir., decided April 6, 1949), 173 F. 2d 805.

The doctrine of constructive receipt has been incorporated in the Treasury Regulations from the beginning and is set forth in Regulations 101, Article 42-2, in effect in 1939, as follows:

> "Income not reduced to possession.—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so

credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt."

Thus, if income—whether in the form of cash, stock or other property—is available to a taxpayer "without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made," such income will be deemed to have been constructively received, although not reduced to actual possession. *John A. Brander,* 3 B. T. A. 231, 235; *Burns v. Commissioner* (5 Cir.), 31 F. 2d 399, 401, cert. den. 280 U. S. 564; *Schoenheit v. Lucas* (4 Cir.), 44 F. 2d 476, 481; Regulations 101, Art. 42-2, *supra.*

In the present case the shares received by Northrop under his contract dated June 17, 1939, were unquestionably available to him in 1939. As of November 28, 1939, the facts which fixed Northrop's right to stock and the number of shares to which he was entitled had occurred. His contract with the Company expressly provided that his "rights to shares hereunder shall be deemed to have accrued as of the date of sale of the shares which shall have determined his right thereto . . . notwithstanding the date of actual issuance thereof to Northrop" [Ex.

3-C]. At the end of 1939 there still remained to be complied with two conditions prescribed by the Commissioner of Corporations before the certificates to which Northrop is entitled could be issued. These were (1) execution and filing of the waiver agreements required by conditions (c) and (d) of the permit, and (2) obtaining the Commissioner's written approval of an escrow holder for the certificates. It is submitted that there is no evidence whatsoever that these conditions constituted a "substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made."

The execution of the waiver agreement and the filing of a copy thereof with the Commissioner were clearly matters solely within the control of Northrop. He could elect at any time when these acts were to be done. The fact that the Company was a party to the actual waiver agreement entered into [Ex. 16-P] is wholly immaterial, for the Company did not agree to anything it was not already bound to do under its prior contract with Northrop, and by the terms of the permit was not required to agree to anything.

Nor was the requirement that the Commissioner of Corporations approve the Bank of America National Trust and Savings Association as an escrow holder a substantial condition. Northrop, as president of the Company at all times since its inception [R. 68], was in a position at any time he chose to apply on behalf of the Company to the Commissioner for approval of the escrow holder previously designated by the Company's directors. When the Commissioner's approval of the Bank of America National Trust and Savings Association as escrow holder was sought in January, 1940, it was forthwith granted. In view of the nationally recognized position of

the Bank of America National Trust and Savings Association in the California banking field and the uncontradicted testimony of the Assistant Commissioner of Corporations [R. 198-199], there is no reason to doubt that such approval was a mere formality.

The situation in the present case as regards constructive receipt is similar to that in *Aramo-Stiftung v. Commissioner* (2 Cir.), 172 F. 2d 896. There the taxpayer, a foundation organized under the laws of Leitchtenstein, was the beneficial owner of American securities which were registered in the names of brokers or their nominees. The securities were kept in a safe deposit box rented by a New York corporation, organized for the purpose of acting as custodian of the securities. Dividends were paid by the issuing corporations to the brokers, as registered owners, and the brokers retained them as unclaimed funds. In July, 1945, the taxpayer advised the brokers that it was the owner of the securities, requested them to pay the income taxes due for the years 1940 through 1945, and asked them to transfer the balance to accounts in taxpayer's name. All of the brokers refused, asking more satisfactory evidence of taxpayer's ownership of the securities, and in some cases requesting guarantees against possible conflicting claims, and stating that a Treasury license would be necessary. The Tax Court held that dividends received by the brokers during the years 1940-1943 were constructively received by taxpayer in those years, and the Court of Appeals affirmed, stating (p. 897):

> ". . . These dividends were immediately available to petitioner upon its proof of ownership, its obtaining the appropriate license, and in some cases its presenting requested guarantees. There is no evidence that petitioner could not have complied with these requirements if it had attempted to do so, or

> that there were any conflicting claims to the dividends. In other words, we agree that petitioner constructively received the dividends, for nothing in the record indicates that there was any 'substantial limitation or restriction' on its right to get actual possession of them at any time it chose really to go after them."

The requirements of the Corporation Commissioner in the present case as to waivers and approval of an escrow holder are strikingly similar to the requirements as to proof of ownership, execution of guarantees and obtaining a Treasury Department license in the *Aramo-Stiftung* case. It is submitted that here also there is nothing in the record to indicate that there was any substantial limitation or restriction on Northrop's right to get actual possession of the shares at any time he "chose really to go after them."

3. The Rights to Shares Received by Petitioners in 1939 Constituted the Equivalent of Cash to the Extent of Fair Market Value, if Any, in That Year.

Although the term "equivalent of cash" has been called largely a misnomer (2 Mertens, Federal Income Taxation, Sec. 11.02), we believe that, properly used and defined, it furnishes a useful tool to demonstrate the soundness of our position with regard to the year of receipt of income by petitioners.

As a preliminary step, let us see what is meant by the term "equivalent of cash." The elementary concept of income as solely cash received was, of course, long ago abandoned in tax law. Various economic benefits, other than cash, have long been treated as taxable income, and this is true whether the taxpayer is on a cash or accrual basis.

As stated by the Supreme Court in *Commissioner v. Smith,* 324 U. S. 177, 181:

> "Section 22 (a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

Mertens in his treatise on "The Law of Federal Income Taxation" devotes an entire chapter to "Income and Deductions in the Equivalent of Cash" (Vol. 2, Ch. 11). He states in Section 11.02:

> "The term 'equivalent of cash' as used in the determination of liability for income tax is largely a misnomer. Basically the term means that property has been received which is other than cash and which has a fair market value. It implies that the value is just as determinable as though cash were received, also that the taxpayer has something which is presently disposable the same way as cash is disposable. The term, however, has taken on over the years a broader meaning. Occasionally it means receipt of benefits and at other times it may mean a substitute for income or a flow of satisfaction or a benefit accrued. A review of comparatively recent cases indicates that the old doctrine of equivalent of cash is outmoded and that an entirely new orientation of this concept is required."

Although The Tax Court did not define "equivalent of cash" in its opinion, the term can have only its basic meaning in the present case, namely, that presently disposable property has been received which is other than cash and which has a fair market value. 2 Mertens, Sec. 11.02,

supra. In finding that the Northrop promotional shares had a fair market value of $4.00 a share as of March 4, 1940 [R. 49], The Tax Court was itself applying the equivalent of cash doctrine as defined above. As evidence to support its finding that petitioners in 1940 received the equivalent of cash, The Tax Court relied almost wholly upon the Ellsworth-Smith transfer which was consummated November 28, 1939 [R. 39-40], referring to it as "the best available indication of the approximate value of the promotional shares." [R. 55.]

For reasons hereinafter stated, we believe that the Ellsworth-Smith transfer furnishes no evidence of fair market value of Northrop's shares on November 28, 1939, or on March 4, 1940, or on any other date. If we are correct in this, then Northrop did not receive the equivalent of cash either in 1939 or in 1940. However, if the Ellsworth-Smith transfer is any evidence that the Northrop shares had fair market value on March 4, 1940 (which we do not concede), it is equal or stronger evidence that Northrop's rights to shares had fair market value on November 28, 1939, and that such rights constituted the equivalent of cash.

The Tax Court attempts to avoid this obvious inconsistency in its decision by "rejecting" the application of the equivalent of cash theory on the ground that "we do not think that petitioners accepted these contract rights as payment." [R. 52.] In answer to this, it may be pointed out first that there is nothing in the record to support The Tax Court's statement that the "contract rights" were

neither given nor accepted by petitioners as payment of the Company's undertaking to issue shares. On the contrary, the evidence shows that the parties were not particularly concerned with when the certificates evidencing their shares might be issued, but were vitally concerned with the date that their rights to shares "accrued." Such evidence is found in the language in each of the six contracts for issuance of promotional shares [Exs. 3-C to 8-H, incl.] to the effect that each individual's rights to shares "shall be deemed to have accrued as of the date of sale of the shares which shall have determined his right thereto." Further evidence on this point is furnished by the fact that while the stock certificates unquestionably could have been issued within a few days after November 28, 1939, the parties did nothing about it until January, 1940, and did not cause the certificates actually to be issued until more than three months had elapsed after their rights thereto had accrued. [Stip. pars. 29-34, R. 72-74.]

This brings us to our second point on the payment question. The Tax Court cited four cases (*San Jacinto Life Insurance Co.*, 34 B. T. A. 186; *Frank Kuhn*, 34 B. T. A. 274; *Great Southern Life Insurance Co.*, 33 B. T. A. 512, affirmed 89 F. 2d 54, certiorari denied, 302 U. S. 698, and *Schlemmer v. United States*, 94 F. 2d 77) to support its conclusion that the equivalent of cash theory has no application to the present situation. All of these cases involved promissory notes, and it is submitted that they are not in point, because in each there was simply a substitution of new evidence of indebtedness for a pre-existing money obligation. It may be noted in passing

that in *Schlemmer v. United States, supra,* there was actual testimony that the note in question was not taken in payment, but only as more permanent evidence of the debt (94 F. 2d at 78). But whatever the rule may be as to whether the giving of a promissory note constitutes payment (*Cf. Anthony P. Miller, Inc. v. Commissioner* (3 Cir.), 164 F. 2d 268), we submit that such rule has no application to the present case, which involves shares of stock and not obligations to pay money.

The distinction between a simple money obligation and an obligation to sell or issue stock not readily procurable elsewhere is instantly apparent. An obligation to pay money is generally enforceable only at law, and is treated as a receivable until actually paid in cash or by check or in some instances by promissory note. An enforceable contract to convey land, or a unique chattel, or shares of stock which are not readily obtainable elsewhere, on the other hand, is enforceable in equity and operates to create an equitable title to such property in the vendee. As heretofore pointed out, the petitioners by November 28, 1939, had acquired a well defined property interest, specifically enforceable in a court of equity. To paraphrase the term used by The Tax Court, they received in 1939 at least the "equivalent of shares." If such equivalent of shares had a fair market value in 1939 (as The Tax Court impliedly found), then the petitioners received the equivalent of cash in that year, and The Tax Court should have so held.

B. The Valuation of Petitioners' Stock at $4 Per Share Is Arbitrary, Excessive, Not Supported by the Evidence, and the Result of Fallacious Reasoning.

1. The Ellsworth-Smith Exchange Is No Evidence Whatever of the Fair Market Value of Petitioners' Stock.

The finding and decision of The Tax Court that the Class A shares and Class B shares received by petitioners had a fair market value of $4 each is predicated squarely on the Ellsworth-Smith exchange. This transfer is said by the Court to be "the best available indication" of value of the promotional shares and to offer "a reliable approximation of value." [R. 55.] The process followed by the Court was to make a small adjustment from the value paid by Smith in that transaction, and apply the adjusted figure directly to petitioners' stock.

If, therefore, application of the Ellsworth exchange to petitioners' stock is erroneous either because there is no connection between them in logic, or because in making its adjustment the Court neglected to give effect to an important difference between the stock involved in the two cases, the Court's finding and conclusion as to value loses its entire foundation and must fall. We propose to show that the Court erred in both these respects.

(a) The Value Paid for All of Ellsworth's Stock Bears No Logical Relation to the Value of All Petitioners' Stock.

Here we propose to show that the reasoning followed by the Court is necessarily and inherently fallacious. The error committed by the Court is plain and fundamental. The fallacy lies in determining the average amount per share paid by Smith for all Ellsworth's stock, and applying that average (even with the slight adjustment made by the Court) to all of petitioners' stock. The analysis of this obvious logical fallacy follows.

(1) *The "Average" Method Makes a Wholly Arbitrary Comparison Unless A and B Shares Had the Same Value.*

The stock transferred in the Ellsworth-Smith transaction consisted of 1,538 A shares and 2,307 B shares—a ratio of 2 A shares to 3 B shares. [Findings, R. 39.] The Court said the transfer indicates an approximate value of $4.50 per share—that is, for the whole 3,845 shares. By reason of the managerial relationship of Northrop to the Company (not existing in the case of Ellsworth), the larger number of shares in Northrop's case, and the unproved position of the Company, the Court slightly reduced the $4.50 figure to $4—again for all shares, A and B alike. [Opinion, R. 55.]

Giving effect to this adjustment, then, the Court found that 1,538 A shares plus 2,307 B shares were worth $15,-380—or 2 A shares plus 3 B shares were worth $20. The Ellsworth transaction can possibly be evidence *only* of the fact that this particular combination of shares had this value. The A shares could be worth between $10 per share and zero, and the B shares between zero and

$6.67 per share, the value of each class declining as the other increases, and vice versa.

The stock received by Northrop consisted of 15,384 A shares and 38,461 B shares—a ratio of 2 A shares to 5 B shares. The asserted fact that Ellsworth's stock had an average value of $4 per share is no evidence whatsoever that Northrop's stock had an average value of $4 per share.

To use a homely example: Jones owns two horses and five cows. The question of their value is in issue. Evidence is given that Mr. Smith sold two horses and three cows for $20 for the lot—averaging $4 per unit. It does not follow that Jones' livestock has an average value of $4 per unit or a total of $28.

This is obvious. The fallacy lies in the fact that the proportions of horses and cows are different in the two cases.

In the instant case the same fallacy exists. At an average of $4 per share, Northrop's stock had a value of $215,380. However, an A stock value of $7 per share and a B stock value of $2 per share would be equally compatible with the Ellsworth-Smith transfer, as in his case the average would still be $4 per share; but in such case the value of Northrop's stock would be only $184,610. (The figures used are only for the purpose of illustration.)

The point does not require belaboring. It is simply that reasoning from the Ellsworth exchange without determining the values of A and B shares separately, is impossible where there is a difference in the ratios of the two classes. The only instance in which this obvious logical fallacy does not exist is when the values of A and B shares are identical. We therefore turn to a consideration of the evidence, or absence thereof, to support a con-

clusion that a share of A stock had the same value as a share of B stock on March 4, 1940.

(2) *There Is No Evidence That A and B Shares Had the Same Value, if Either Had Any Value.*

It is of course true that both of petitioners' expert witnesses testified that neither the A shares nor the B shares received by Northrop had any fair market value on March 4, 1940. They gave their opinion that the A shares had no fair market value and that the B shares had no fair market value. This cannot be twisted into evidence that if the A shares had fair market value, the B shares had an equal fair market value. Having reached their opinions that the A shares had no fair market value, it obviously followed (because of the junior position of the B class) that the B shares were in the same condition. The experts could not indicate a lower value for the B shares by giving them "red" or negative value.

What else is there in the record to support the finding (which is indispensable to any reliance whatever on the Ellsworth-Smith exchange) that shares of these two classes had the same value? It is submitted that the most painstaking search of the record discloses no scintilla of evidence to this effect. Certainly the Ellsworth transfer, relied upon so heavily by the Court, is no evidence of *this* purported fact. The Court's effort [R. 54-55] to justify its erroneous conclusion of equivalence in value is considered in detail below.

On the other hand, there is ample evidence that the B shares were so heavily restricted, above and beyond the A shares, that failure to distinguish between them is clearly arbitrary. Thus:

(a) A shares were restricted as to dividends only so long as they should remain in escrow under the

Corporation Commissioner's permit. [Findings, R. 38.] In addition to the same restriction, no dividends could be received on B shares under the Articles of Incorporation until July 1, 1942 and none thereafter unless specified earnings per A share were received by the Company. [Findings, R. 41.]

(b) So long as A shares remained in escrow they could not participate in liquidating distributions until the shares owned by the public had been fully liquidated at the rate of $6 per share. [Findings, R. 37.] B shares suffered from this same restriction indefinitely, even after release from escrow. [Findings, R. 41-42.]

(c) Sixty per cent of Northrop's B shares were subject to an option (not applicable to any of the A shares) held by the Company to purchase the same at 25 cents per share in the event of Northrop's decease or termination of his employment by reason of his default. [Findings, R. 35-36.]

(d) All B shares would become void if no "adjusted net profits" were earned by the Company either during the five-year period commencing August 1, 1939, or during the three-year period commencing August 1, 1941. [Findings, R. 42.] No such limitation was imposed on the A shares.

B shares could escape these heavy burdens and attain parity with A shares only upon conversion into A shares. They would become so convertible on August 1, 1944 only if adjusted net profits had then amounted to 50 cents per Class A share each year for the five-year period commencing August 1, 1939, or for the three-year period commencing August 1, 1941. If such earnings should be less than 50 cents per annum per Class A share for such

period, then Class B shares were to be convertible into a proportionately smaller number of Class A shares. They could become convertible prior to August 1, 1944, only if and when the adjusted net profits computed from either August 1, 1939, or from August 1, 1941, should amount in total to $1,000,000. [Findings, R. 42.]

In the face of these undisputed facts, it is impossible to conclude that shares of these two classes had identical, or even approximately the same, values. Yet without this vital link the chain with which the Court seeks to bind the Ellsworth transaction to the fair market value of petitioners' shares falls in pieces.

(3) *The Reasons Advanced by the Court for Valuing A and B Shares Alike Are Clearly Erroneous.*

In concluding this phase of the argument, it is necessary to consider one by one the reasons advanced by the Court for failing to value separately the A and B shares received by Northrop. The Court frankly admits [R. 54] that it "treated" the shares of the two classes "as equivalents."

Note carefully this wording. The Court does not flatly state that they *were* equivalents, but only that it "treated" them as such. At the outset it is urgently submitted that the Court meant what it said, missing entirely the point made above that the respective ratios of the two classes of stock involved in the Ellsworth transaction differed greatly from those received by Northrop. This conviction is strengthened by the language immediately following, that this treatment was adopted "for convenience and simplicity." [R. 54.] It is obvious that the Court would not have adopted a method or procedure of "treatment" of the case, just because it was more convenient and simpler to do so, if it had realized that by so doing it was involv-

ing itself in a fallacy of logic which was bound to result in an arbitrary and excessive valuation of Northrop's stock. Hence, we reiterate, the Court did not conclude that the B shares actually were the equivalent of A shares in value.

Nevertheless, the opinion does proceed to attempt to support this theory of equivalents on the basis of reality. It makes these points which are disposed of as follows:

(i) The "parties approach the problem" as if shares of the two classes were equivalent. [R. 54.]

The Commissioner's contention for a value of $6.25 per share without distinction between classes cannot, of course be held against or estop the petitioners. The petitioners asserted that the shares of neither class received by them had any fair market value. However, conscious of the possibility that the Court might find some value for the A shares, the petitioners strongly emphasized in their briefs the peculiar burdens that rested on the B shares, of which the A stock was free. The Court's statement, as applied to petitioners, is simply incorrect. They never conceded, or even intimated, that if the A shares had a fair market value the B shares had the same value.

(ii) The limitations imposed on all the promotional stock "virtually eliminated any distinction" between the two classes, "as a practical matter." The junior position of Class B shares does not have "significance" because of the waivers as to dividends and distributions. [R. 54-55.]

Although the limitations imposed by the Commissioner of Corporations applied in common to both classes of promotional shares, the B shares were

burdened by the Articles of Incorporation and the employment contracts with a series of extremely important restrictions which did not apply at all to the A shares received by Northrop. These are detailed above (pp. 42-43). It is just not true that virtually no difference remained between the two classes of shares received by Northrop. And what does the Court imply by its use of the word "virtually" and the phrase "as a practical matter"?

(iii) The option to repurchase has "little significance" because the petitioners were the directors of the Company. [R. 54.]

We ask again, what does the Court imply by using the word "little"? If distinction between the two classes persisted even to a slight degree despite the promotional limitations "virtually" eliminating it "as a practical matter," and despite the option having "little" significance, the Court erred as a matter of law in applying the Ellsworth-Smith average price to Northrop's stock. We respectfully object to the Court attempting to be practical at the expense of being right.

However, the implication that the petitioners, being directors, would refrain from exercising the option regardless of circumstances is untenable. The petitioners at all times constituted a minority of the directors. Northrop was a minority of one; Mrs. Northrop was never a board member. If the right to exercise the option should arise because of Northrop's death, he, of course, would not be there to cast his vote and influence against an exercise. If arising because of termination of his employment by reason of his default under the employment agreement, it may be speculated with reasonable certainty that

his vote and influence would not long persist. The very circumstance giving rise to the right of exercise would necessarily deprive his directorship of all significance.

(iv) Exercise of the option would have resulted in an "increase [of] the value of the Class A shares." [R. 54.]

Even if true, this would not justify averaging Northrop's stock at approximately the same figure as the average price paid for Ellsworth's stock by Smith. By its statement the Court impliedly admits that the option is a depressing factor as to the B stock, but argues that to the extent the B value is depressed thereby the A value is correspondingly increased. But as shown above, ignoring the difference (admitted by the Court here) in value between A and B shares, and then applying the average in Ellsworth's case to all Northrop's shares without recognizing the difference in the relative proportions of the two classes in the two cases, renders the logical process wholly invalid.

However, the statement is demonstrably untrue as applied to the Northrop stock, for the following reasons:

First—If the Court means anything by this assertion it must mean that upon exercise of the option the full value theretofore represented by Northrop's A and B shares combined, would thereafter inhere in his A shares. Let us test this dictum:

At $4 per share the Northrop A stock (15,384 shares) would be worth $61.536 and his optioned B stock (23,077 shares) would be worth $92,308. The Court says that if the optioned B shares were purchased at 25 cents per share (a total purchase price

of \$5,769), the difference between this purchase price and the asserted value of such shares (\$92,308) would be added to his A shares. Adding this difference of \$86,539 to the former A share value of \$61,536 produces a value of \$148,075 for these 15,384 shares, or \$9.63 per share. Thus the Court in essence says that even if Northrop's optioned B shares were actually worth only 25 cents each, his highly restricted A shares were really worth at least \$1.63 per share more than the highest price paid for unrestricted A shares at any time during the year 1940, *i. e.*, \$8 per share. [R. 48.]

Second—Of course, the Court's error which leads to the absurd result just shown lies in assuming that the purchase of Northrop's optioned B shares would benefit Northrop's A shares alone, to the exclusion of all other A shares. This assumption is obviously wrong. Here are the actual mathematics of the case:

If Northrop's optioned B shares having a postulated worth of \$4 per share, were purchased by the Company at 25 cents per share, Northrop would thereby incur a loss of \$3.75 per share, or a total loss of \$86,539. The Court says the value of his A shares would be increased by the same amount. On the contrary, this amount would redound equally to the benefit of the approximately 280,000 A shares outstanding [R. 46], at the rate of less than 31 cents per share. Northrop's 15,384 A shares would benefit only to the extent of about \$4,750. Far from breaking even on the transaction, as the Court says he would, Northrop would have a net loss of approximately \$81,789.

(v) "The provision calling for cancellation of Class B shares . . . if they failed to become

convertible" has no significance because such cancellation would occur only if there were no adjusted net profits, and therefore the A shares "would have remained in escrow subject to the waivers." [R. 54.]

First, it should be noted that the Court has its facts wrong. In actual fact 5,240 of his A shares were released to Northrop on November 19, 1940 [R. 41], whereas the Company had no net earnings until its fiscal year ending July 31, 1942 [R. 47] and none of the Class B shares became convertible until August 1, 1942 [R. 42].

In the second place the Court overlooks entirely the very reasonable possibility that the Company might have some earnings, but less than the rate required to permit conversion of all B shares on a share for share basis. In that event, the B shares would be convertible into a proportionately smaller number of A shares, and the A shares would be released from the escrow and the enforced waivers.

Aside from these factual errors, the only meaning we can read into this statement is that in the circumstances supposed by the Court Northrop would be no worse off with only his A shares than he would with both A and B, because the latter would be worthless both before and after cancellation. It is implied that in this situation both classes of promotional stock would be worthless, and hence both may be valued alike; and further that the A shares would be worthless because they would be still "in escrow subject to the waivers."

If being "in escrow subject to the waivers" causes worthlessness, then all the stock received by Northrop was without fair market value as contended by petitioners and contrary to the Court's conclusion.

Yet no other reason is suggested why the A shares would be worthless in the supposed circumstances.

Perhaps too much space has been devoted to the Court's self-justification for its treatment of A and B shares received by Northrop as equivalent in value, share for share. But this point is of the very essence. For if, as contended by petitioners, there is no evidence in the record that the two types of shares had equal value, and the Court's reasons for concluding that they did were all erroneous, then it inevitably follows that application to all Northrop's shares of an average derived from Ellsworth's exchange of his shares is necessarily productive of an arbitrary value unsupported by any evidence.

(b) The Court's Failure to Give Effect to the Company's Option as to a Portion of Northrop's B Shares in Applying the Ellsworth Exchange Price to Northrop, Is an Error of Law.

The Court says that in translating the Ellsworth exchange price of approximately $4.50 per share into a value of $4 per share for Northrop's stock, it gave consideration and effect "to such factors as" the managerial relation of Northrop to the Company, the large number of shares he received, and the unproven position of the Company. [R. 55.] The Court does not here list the Company's option which affected 23,077 of his B shares—almost 43 per cent of his total stock. Nor can it be contended that this factor was included within the embrace of the phrase "such factors as," because the Court squarely negatives this possibility by saying:

> "The Company's option to repurchase the promotional Class B stock for 25 cents a share seems to us to have little significance for evaluation purposes . . ." [R. 54.]

Failure to give effect to this vital difference between Ellsworth's stock (none of which was subject to any such option) and Northrop's stock is a clear error of law that renders arbitrary and excessive the Court's conclusion. This distinction robs the Ellsworth sale of all probative value it might otherwise have had.

That such an option has an extremely important effect on fair market value is established beyond any doubt by numerous decisions. In option cases where there is in existence a presently exercisable right in another to compel the owner of property to sell it at a fixed price, that option price is uniformly held to constitute the absolute upper limit of the fair market value of the property subject to the option. *Helvering v. Salvage,* 297 U. S. 106, 109; *Lomb v. Sugden* (2 Cir.), 82 F. 2d 166; *Wilson v. Bowers* (2 Cir.), 57 F. 2d 682; *Estate of Anna D. Childs,* T. C. Memo. Dec. Docket No. 111,548, 6-30-43; *Estate of John Q. Strange,* B. T. A. Memo. Dec. Docket No. 106,936, 4-29-42; *Edith M. Bensel et al., Executors,* 36 B. T. A. 246, aff'd. *sub. nom. Commissioner v. Bensel* (3 Cir.), 100 F. 2d 639; *Helen S. Delone,* 6 T. C. 1188.

In cases where the option price is not irrevocably fixed (such as an option to buy stock at its book value sometime in the future as involved in *Commissioner v. McCann* (2 Cir.), 146 F. 2d 385; *Behles v. Commissioner* (7 Cir.), 87 F. 2d 228; *C. T. Kline,* 44 B. T. A. 1052, aff'd. 130 F. 2d 742, cert. den. 317 U. S. 697), or where the owner is bound to offer property to another on certain terms only *if* he should desire to sell (as in *Worcester County Trust Co. v. Commissioner* (1 Cir.), 134 F. 2d 578; *Krauss v. Commissioner* (5 Cir.), 140 F. 2d 510; *Halsted James,* 3 T. C. 1260, aff'd. (2 Cir.) 148 F. 2d 236), the existence of the options has uniformly

been held to have a depressive effect upon the market value of the optioned property (as compared with similar property free from the option) even though the option price in such cases has not been treated as fixing a ceiling on market value.

In this case, the option price was not dependent upon future uncertainties, but was irrevocably fixed at 25 cents per share. And the exercise of the option was in no way dependent upon the desire of petitioners to sell, but only upon the sole discretion of the Company in either of two events: (1) Northrop's death or (2) termination of his employment contract by reason of his default. The first condition, at least, was one wholly beyond the control of petitioners or anyone who might buy their option shares,—a condition which might happen at any time, leaving the holder of the stock no choice but to sell at the fixed price of 25 cents per share if the Company should see fit to exercise its option. And the second condition, even if the matter of default under his employment contract be thought to be within Northrop's control, was subject to no volition on the part of any purchaser of the stock.

In these circumstances, we submit that the instant case falls within the rule that a definitely fixed option price, at which an owner of property can be compelled to sell to an option holder irrespective of the owner's desires in the matter, constitutes the maximum limit of the fair market value of the property subject to the option. Petitioners' 23,077 Class B shares subject to the Company's option thus could not properly be found to have a fair market value in excess of 25 cents per share.

And even if the option here, because of the conditions applicable to its exercise, be thought not to fall within the above rule, then at the very least the option was a

depressive factor with relation to the market value of the optioned stock which the Court erred in disregarding or in relegating to a position of "little significance." A prospective purchaser of petitioners' optioned stock would, of course, realize that if Northrop should die or should default under his employment contract within the option period (events over which the purchaser could have no control), he might be compelled to sell that stock to the Company at 25 cents per share. It is incredible that such a purchaser would be willing to pay as much for any property subject to such an option as he would for like property not so encumbered.

Thus, whether the option be regarded as fixing an upper limit on the fair market value of the Class B shares affected thereby, or merely as a depressive factor with respect to such value in relation to the value of similar unoptioned shares, The Tax Court's failure to give effect thereto constitutes an error of law. This error is particularly obvious, and fatal to the Court's conclusion, because about 43 per cent of the property received by petitioners was subject to the option, and therefore a different kind of property (at least from a valuation standpoint) from any of the property involved in the Ellsworth-Smith transaction. The two cases are plainly and simply not comparable to each other.

(c) The Ellsworth-Smith Transaction Is Entitled to Little or No Weight Because of Its Isolation, the Personal Solicitation and Negotiation Required, and Other Like Factors.

It has been shown above that the Ellsworth transfer is in no way pertinent to a determination of the fair market value of the stock received by petitioners, first, because of the difference in ratios of A and B shares in the two instances, and second, because none of Ellsworth's stock

was subject to the 25 cents option which affected about 43 per cent of Northrop's stock. It is now submitted that even if there were some relevance between the Ellsworth transaction and the value of petitioners' shares, still the circumstances of the Ellsworth-Smith trade were such that it could properly be given little or no weight as evidence of fair market value of even the very kind of shares which it involved. Yet it is perfectly apparent from The Tax Court's opinion that overwhelming weight was ascribed to it in reaching the decision.

The Ellsworth transfer was, as admitted by the Court [R. 55], an isolated transaction, no other sale or exchange of promotional stock having been made prior to termination of the escrow. The Court's characterization of this as a "*somewhat* isolated transaction" (emphasis added) is a masterpiece of understatement. That transaction (1) occurred more than three months prior to the valuation date, (2) was the result of personal solicitation and negotiation over a period of 90 days with a party particularly interested in Southern California aviation stocks, (3) involved only 10 per cent of the number of Class A shares and only 6 per cent of the number of Class B shares held by petitioners, and (4) involved payment of a 12 per cent commission or profit to the intermediary negotiating the transaction. [R. 39, 129-130.] These peculiar and unusual circumstances are sufficient in themselves to deprive that transaction of any substantial weight as evidence of fair market value, and one of petitioners' expert witnesses so testified. [R. 191.] See *Wood v. United States* (Ct. Cls.), 29 Fed. Supp. 853 (isolated transaction involving relatively small block of shares); *Heiner v. Crosby* (3 Cir.), 24 F. 2d 191 at 193 (sales of small lots); *Phillips v. United States* (W. D. Pa.), 12 F. 2d 598 at 601 (sales of small lots); *Daniel Kelly, et al.,* 10 B. T. A. 141 at 155

(personally solicited sales); *Frederick H. Zeigen,* 10 B. T. A. 844 (personally solicited sales in small lots at high commission rate); and *Premier Packing Co.,* 12 B. T. A. 637 at 644 (high commission rate).

2. There Is No Other Evidence to Support the Court's Valuation.

We have shown that Ellsworth's exchange of his shares cannot be logically related to the issue of valuation of petitioner's stock, and that the former affords no support for the Court's decision. We have made the point that the Ellsworth transaction was obviously the prime cause for the valuation of $4 per share placed by the Court on all the stock received by petitioners. Any argument that the Court's error does not require a reversal because it said also that it had considered "all the other pertinent evidence bearing on value" would be the merest quibble. As to this, we rest upon the language of the opinion. [R. 55.]

We now propose to show that there is no evidence in the record that securities of the kinds received by petitioners had any fair market value whatever. To this end it is necessary to give careful attention and analysis to the various securities which were issued by the Company, and to segregate those portions of the evidence which relate severally to the different kinds of securities which were issued.

In order to avoid the pervasive error into which The Tax Court fell it is essential to list the different kinds, categories or types of securities issued by the Company. These are:

Type 1—A shares sold to the public.

Type 2—Warrants to purchase A shares.

Type 3—Escrowed A shares owned by persons not occupying responsible management positions (such as those which Ellsworth was entitled to receive).

Type 4—Escrowed B shares owned by persons not occupying responsible management positions.

Type 5—Escrowed A shares owned by persons vital to the Company (such as those which Northrop received).

Type 6—Escrowed B shares owned by persons vital to the Company.

Type 7—Escrowed B shares which were subject to the option to repurchase.

The provisions contained in the articles of incorporation, Northrop's employment contract, the Corporation Commissioner's permit and the agreements executed as required therein, in combination created most substantial and important differences between any one of these types of securities and each of the other six types. These were so basic as to cause the securities themselves to differ in kind, not merely in degree.

The Court did not purport to predicate its conclusion on the value of the warrants, so their relationship to the other types of securities needs not be dwelt upon. It recognized that the value of the A shares sold to the public bore no direct relation to the value of the shares in issue. This leaves for consideration Types 3 to 7, inclusive.

The securities sold by Ellsworth were of Types 3 and 4. Those received by Northrop were of Types 5, 6 and 7. The differences between them are:

(a) The effect of managerial ownership, affecting Types 5, 6 and 7, but not Types 3 and 4; and

(b) The option to repurchase at 25 cents a share, affecting only Type 7.

It has already been noted that the Court expressly recognized the validity of the first of these differences, giving it as one of the reasons for reducing the Ellsworth-Smith sale figure of $4.50 to $4. The Court felt that this difference, in combination with discrepancy in the size of blocks of shares involved and the unproved condition of the Company required the adjustment of 50 cents a share (although the last of these three factors obviously bears in no way on a comparison of the value of Ellsworth's shares with those of Northrop).

Although the Court did thus attach some significance to the managerial relationship of Northrop to the Company, it is submitted that it failed to realize that the managerial factor makes the shares of Types 5 and 6 truly a different *kind* of property as to valuation from what would otherwise be their counterparts, Types 3 and 4.

The evidence to this effect is definite, unqualified, uncontradicted and unshaken by cross-examination. The witness Lester, president of one of the underwriters, also one of the directors of the Company at and before the basic date [R. 139], a qualified expert witness, testified that his opinion that the shares received by Northrop had no fair market value was based in part on the fact that Northrop, Cohu, Irving, Bellande and Stevens were the foundation upon which the whole corporation, and the sale of its stock, was based [R. 144]; that with that group, and its peculiar experiences, being tied in to the Company, there was a substantial financial prospect for success of the Company [R. 145-146]; that that particular group was responsible for the marketing of the securities [R. 146] and that no informed investor would have paid anything

for the stock of any of those men. [R. 146.] On cross-examination he testified that if any of these men had offered their shares for sale, it would have dissipated the confidence of the public in the enterprise [R. 161]; that if he had known of an offering by one of these persons he would have recommended to his customers to dump their shares quickly for anything they might get, and that they would not have received any value for the stock in those circumstances [R. 162]; that he would have persisted in such advice up to the point where there was no orderly market left [R. 169], and that by reason of the effect on the market and the weakening of the Company's competitive position which would have ensued, there would have been only a salvage operation left. [R. 170.] Lester also testified [R. 150] that he had taken the Ellsworth transaction into consideration and that it was entirely different for him to have dropped out of the enterprise than would have been the case with Northrop; that it was not contemplated that Ellsworth had any interest in the Company and that he had no official position with the Company, nor any background in the aircraft industry.

There can be no doubt of Lester's qualifications as an expert—they were not questioned in any respect by the Government. Nor can it be gainsaid that Lester was an "insider" and understood the circumstances and the various factors that made possible a marketing of any stock at all, and that would have affected the market for this stock in the event of an offering by Northrop of any portion of his stock. His testimony as to the difference between a sale by Ellsworth and a sale by Northrop, as well as all his other testimony referred to above, make perfectly clear the difference in kind between shares of Types 3 and 4 owned by Ellsworth and shares of Types 5 and 6 owned by Northrop.

The differences between Types 3 and 4 on the one hand, and Type 7 on the other are even more striking. In the first place, since Type 7 was received only by those persons who held important positions of management with the Company, the differences already discussed are present in this comparison also. In addition, there is the most important distinction that the Company's option to repurchase at 25 cents a share applies only to the shares of Type 7, and not to shares of any other type. This vital distinction was airily brushed aside by the Court with the statement that it "seems to us to have little significance for evaluation purposes" for the reasons stated in the opinion immediately thereafter and discussed at length above (pp. 46-48). The authorities amply demonstrate that the existence of such an option puts the shares affected thereby into an entirely different category for valuation purposes from similar shares not affected by such an option (see discussion at pp. 50-53 above).

Because of these differences in kind among the various types of securities issued by the Company, the following question assumes the utmost importance: What evidence is there in the record as to the value of shares of Types 5, 6 and 7?

The evidence offered by Northrop consists of the opinions of two admittedly qualified experts, both of whom testified that all of Northrop's shares, including his Class A shares, his Class B shares not subject to the option, and his Class B shares which were subject to the option, had no fair market value. [R. 143-144, 183-184.] The Government offered no evidence whatsoever to rebut this testimony. It contented itself to attempt on cross-examination, first, to shake the witnesses in their opinion by asking a series of questions which were well calculated

to produce that result had it been possible, and second, to elicit by cross-examination the general prospects of the aircraft manufacturing industry in the circumstances which existed in 1939 and 1940, and the specific prospects of Northrop Aircraft, Inc. The Government did not succeed in shaking the opinion of the witnesses. It did succeed in showing a fact which was never questioned by Northrop, nor was attempted to be hidden or beclouded on his behalf, namely, that the Company, despite the refusal of the market to absorb the number of shares which had been deemed necessary to be sold in order to produce the required working capital [R. 44-45], despite the slowness with which anticipated orders were being received [R. 46, 156], and despite the knowledge by March 4, 1940, that work already undertaken would show a loss [R. 93] whereas it had been anticipated that it would break even [R. 90-91], still had prospects for success in the business and for obtaining its reasonable share of the military aircraft orders which had been increasing and which it was reasonably anticipated would continue to increase. Without these favorable factors the underwriters would not have been able to dispose even of the 250,000 shares which they managed to sell, out of a planned sale of 400,000 shares. Without these favorable factors the market for the unrestricted Class A shares which had been sold to the public would not have remained even as high as the minimum $5 per share figure at which shares of this type sold during the year 1940. [R. 48.] Without these favorable factors, the Company would have been doomed to the failure which engulfs such an extremely large percentage of new business enterprises.

What the Court failed to recognize, and in so failing committed a clear error, is that the generalities of this kind appearing in the stipulation of facts and the testi-

mony afford no evidence that any of the types of security other than the unrestricted Class A shares sold to the public for cash had any fair market value.

We comb the record in vain for any evidence whatever that the highly restricted shares received by those persons who held positions of important managerial responsibility to the Company, indeed constituted the backbone of the entire structure, had any fair market value. The testimony of the qualified experts on this issue remains wholly uncontradicted and therefore should have been accepted by the Court as conclusive. *Belridge Oil Co. v. Helvering* (9 Cir.), 85 F. 2d 762; *Boggs & Buhl, Inc. v. Commissioner* (3 Cir.), 34 F. 2d 859. The failure of the Government to offer any testimony whatsoever on the issue of valuation, whether by way of expert witness or otherwise, is of vital significance. In these circumstances not only is the Court unjustified in substituting its own arbitrary judgment of value for that of the experts, but it has no choice but to find in accordance with the uncontradicted expert testimony which remains unrebutted by any evidence offered on behalf of the Government.

Far from supporting The Tax Court's determination, the indirect evidence relating to the types of shares received by Northrop fully confirms the opinions of petitioners' experts. It is established that restrictions upon the sale of a speculative security may deprive it of fair market value.

Stock in a hazardous, speculative and uncertain undertaking was held to be without fair market value in *Tex-Penn Oil Co. v. Commissioner* (3 Cir.), 83 F. 2d 518, reversing the Board of Tax Appeals. The Supreme Court affirmed the Court of Appeals in *Helvering v. Tex-Penn Oil Co.* (1937), 300 U. S. 481. There the Com-

pany's bankers required the stockholders to agree not to sell or dispose of their stock for a 90 day period, which was renewable at the bankers' option for another 90 days. The Court of Appeals said (p. 523):

> "The determination of the value of the stock on August 1, 1919, was a mere speculative guess and a three or six months' restriction on its sale makes the guess wilder and more speculative."

To the same effect are *State Street Trust Co. v. U. S.* (D. Mass., 1941), 37 Fed. Supp. 846, affirmed *sub. nom. U. S. v. State Street Trust Co.* (1 Cir.), 124 F. 2d 948; *Propper v. Commissioner* (2 Cir.), 89 F. 2d 617; *Schuh Trading Company v. Commissioner* (7 Cir.), 95 F. 2d 404.

In this case the promotional stock was highly speculative and hazardous, the company new and untried. Even the unrestricted Class A shares sold to the public were referred to thus in the prospectus [Ex. 1-A, p. 1]: "These securities are offered as a speculation." Added to the company's inability to sell more than 5/8 of the stock which was offered to the public [R. 42-44] was the fact that more money was spent in the construction of the plant than had been planned [R. 146.] On the valuation date it had only one contract [R. 91] on which it had made no deliveries and was losing money [R. 96], had no immediate prospects of obtaining additional business [R. 91] and was approaching a financial crisis which it barely succeeded in surmounting. [R. 147.] It is hard to imagine an undertaking that would be any more hazardous, speculative and uncertain, yet have a fighting chance to survive,

than was Northrop Aircraft, Inc. on March 4, 1940. In the light of these circumstances and the restrictions on free marketability of the petitioners' shares the Court was not justified in concluding that their shares had any fair market value.

On top of all this the petitioners' stock was completely subordinated to the publicly owned A shares, by the combination of the articles of incorporation, the Corporation Commissioner's permit and the waivers that were required of petitioners. The calculated effect of these various burdens was to make the value of the promotional stock entirely contingent upon the Company's achieving a sufficient measure of success to make secure the investments of the cash-paying public stockholders. The stock was issued to the organizers as a purely contingent reward for their past services, depending wholly for its value upon the success of their future efforts. These shares were well characterized by the witness Bateman as "a call on stock if the company was successful." [R. 188.]

At March 4, 1940, the Company had not yet achieved that degree of success necessary to give a present value to petitioners' stock. The cumulative effect at that date of the Company's precarious financial condition, the subordinate position of the petitioners' stock and the impediments to its sale, the managerial relation of Northrop to the Company and the 25 cent repurchase option affecting 43 per cent of his stock fully justifies and supports the opinions of the experts and renders The Tax Court's conclusion clearly erroneous.

Conclusion.

For the reasons set forth above the petitioners submit that the judgment of The Tax Court should be reversed and the case remanded with the instruction that petitioners received no taxable income in the year 1940 on account of their stock in the Company.

Respectfully submitted,

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